Transcript: How to Invest in Businesses You Trust

David Kuo speaks to author LJ Rittenhouse

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David:

This is Money Talk, the weekly investing podcast from The Motley Fool. I am David Kuo, and today I am delighted to chat with somebody I never tire of talking to. My guest is a financial strategist, and a keen analyser of shareholder letters. My guest is an expert on corporate governance, candid communications and corporate culture. There is one more reason why I like talking to my guest: it's because it's about as close as I will ever get Warren Buffett. My guest is L J Rittenhouse, author of *Doing Business With People You Can Trust*. Welcome to Money Talk, Laura.

Laura:

Good morning, David -- nice to be here.

David:

Well, it is very nice to talk to you again. It's been too long since the last time.

Laura:

I absolutely agree.

David:

Okay, so shareholder letters is something that you are very, very passionate about. What exactly is a shareholder letter, Laura?

Laura:

Shareholder letters are found in the public annual reports published by companies, and it is, in my view, one of the most revealing documents that an investor can go to to find out the quality of leadership, the quality of the corporate culture, and what they can expect from a company.

David:

But ultimately, why should an investor be influenced by what a CEO writes in his shareholder letter?

Laura:

The letter is an indicator -- what does an investor want to know? They want to know, is this a company I can trust? Many times I speak to the bookstore in Omaha, which has the franchise to sell Warren's books at Warren Buffett's shareholder meetings. Now, Omaha is the heart of Buffett territory, of course, and often when I call, one of the first things they'll ask me is, how is the market doing, because I'm calling from New York. I will respond, well, who cares? It's up, or it's down. You people in Omaha know from Warren that what really matters is long-term performance. So if you're an investor that really is looking for a company to put your money in over time, where you can sleep at night, it's really important to read the shareholder letter, because that's where you get an indication of how much trust you want to extend to that company.

David:

But ultimately, Laura, are you talking about a specific group of shareholders who are perhaps initiated in some way? Because the majority of shareholders that I come into contact with are only interested in how much profit the company has made this year compared to last year, and their benchmark is, if the company has made more profit this year than last year, I'm happy. If it's made less profit, I want to know why. So are we talking about two different groups of shareholders here?

Laura:

Perhaps we are, David. One is the short-term shareholder, or stock flipper. I think currently, as recently as five years ago, a mutual fund manager held stocks for on average a year or plus, now it's down to nine months or less, so they don't even hold the stock for a year. But for people that care about investing in a company, looking at the fundamentals, and knowing that this is a company that, over time, markets will go down, they'll go up, but over time it will perform, and it will perform better, and most importantly, you won't have a situation like an AIG or a Bank of America, or an Enron, or any of the companies that, where high fliers show great earnings growth over time, and then investors lost everything.

David:

Okay, so with regard to the shareholder letters, are you somebody who believes that the shareholder letters should be written by the CEO himself, or herself?

Laura:

I did an interview with Warren Buffett a number of years ago, and that was the very question that I asked him -- why should CEOs write their own shareholder letters? Warren replied: "Well, I want to be sure that they understand their businesses, because some CEOs don't understand their businesses." That's one of the first things that you want to look for when you read a letter, is it a coherent and understandable and logical explanation of the business? And does it highlight the advantages that a business has, that it is developing and exploiting to achieve financial performance that you can trust over time?

David:

But isn't it also true, Laura, that, when we talk about official communications, like a shareholder letter, it is a very important piece of communication, that a company is giving, not only to shareholders, but also to potential shareholders, and to the wider public? So what is wrong with having it written by a professional PR company who can do a very professional job, ensuring that it is going to be understood by people out there?

Laura:

When people ask me the question, David, about whether or not a CEO wrote their letter, as opposed to a PR company, I often remind them that the importance is not so much the writing, but in the authoring of the letter, taking responsibility for what goes into the letter. Now, whether it's a PR firm or a group, more commonly in my experience, not necessarily an outside PR firm, but people within the company and the corporate communications department, investor relations department, who actually do the heavy lifting in writing the letter, but they do so, and I would assume a PR firm would do so, with a good, solid, in-depth knowledge of what these key indicators are that I've mentioned before. So when you read a letter ... in fact I asked Warren this question -- how can you tell if the CEO really authored the letter? He replied: "Well, it's very much like the Supreme Court's definition of pornography -- you just know!"

David:

I have no idea what you're talking about there, Laura!

Laura:

Hey David -- just do me a favour, look at your thumbprint. That thumbprint is yours -- nobody else in the world has that thumbprint, and a really good shareholder letter is one, again regardless of whether it's a PR person, what my experience is, is the CEO has to be very much involved for this test to be met. That shareholder letter is going to describe the corporate thumbprint. What makes that company, that culture, that leadership, that performance, unique and special? And how does that fire the people that are necessary to be committed to that, to achieve the success that investors want to see?

David:

Okay, well that bit I understand, but my take on CEO is that his job is to make money for shareholders. How can he do that, if he is painting a true-to-life picture of the company, that not only highlights the beauty spots, but also spotlights the warts as well? I, as a shareholder, don't really want to know about the warts in the company, do I?

Laura:

Well, I'm not sure what you mean by warts. A wart can be something that is curable. If it's a problem that the company is facing because of some technology issues or supply issues or something, I personally want to know what problems they're facing, and how they're dealing with them, because as Dickens said, long ago, even the best regulated of families will have problems. So every company has them, and in fact one of the indicators that I look for when we analyse shareholder letters is disclosure on, it's not just the boards that they have, but how are they dealing with them? Because they're going to be there. A company that portrays that kind of balanced picture is one that is going to, more likely, and this is the experience that I've had over the past dozen years, will be able to be more credible, and therefore more trusted. When you have more trust in a business, you're going to have employees who are going to work harder, who are going to be more motivated, who are going to be execute more efficiently, so that again that all translates into superior financial results for investors.

David:

Okay, but the other thing is, Laura, and I go back to the chief executive's role within the company. Sometimes, if we invest in certain companies, the CEO may turn round to the shareholders and say, I tell you what -- this business, in particular when we talk about high technology businesses, this business is much too complicated to try and explain to shareholders. So that's probably why they don't even try -- they don't even try to explain how the business is run, because as far as most shareholders are concerned, or many shareholders are concerned, their eyes will just glaze over, if you try and get too technical about how the business is going to be run. All they care about is, did you make money?

Laura:

Well, those investors who are thinking that are really not understanding how money is made, and they're going to be at a disadvantage. Let me suggest that you read Jeff Bezos's letter from Amazon, 2010. It starts off with a lot of technical words, all the different kinds of software they're using, but that go into the ability to do the incredible searches and the incredible retail offerings that Amazon has been able to produce over the years, where it's transformed itself from a book company into one of the major retailing organisations in the world. Anyone that invested in that stock, when it started, has seen an extraordinary return. But he's able to explain in that letter, and it's not a long letter, but he's able to give me the confidence in that letter that the company is taking advantage of this technology, but able to translate it into a business model that is very understandable, and not only that, that people trust and use more and more, which is increasing the financial performance of Amazon.

David:

Okay, but would you not also agree, when we talk about Warren Buffett, he is really completely different to other chief executive officers, because Warren Buffett's life is in Berkshire Hathaway. But for many CEOs, they are only seen as some kind of interim manager within a business. They are only brought into a business to execute a particular strategy. That strategy could be to try and expand, say, the business in Asia, or that particular business in China, so they're brought in to do a very specific job. So as far as those CEOs are concerned, why should they even bother putting any effort into the letters, because they know they're only going to be there for a couple of years, maybe four years at most?

Laura:

You've touched on something really important, David, and that's the difference between a managerial business culture, and a leadership business culture. Again, your point is well taken -- companies in our annual survey, as you know, we publish a ranking every year, measuring the degree of candour in shareholder letters. We benchmark 100 companies, which is our benchmark survey, and then we correlate those rankings with stock price performance. We've found that companies with higher degrees of candour will outperform companies with low candour. Often times, the proportion of companies with high candour are often the companies which have leadership cultures, or founder cultures; for example, Costco -- Costco has been a long-term high performer in candour; similarly with Amazon. A company that doesn't have a founder culture, but a really strong leadership culture, is Wells Fargo, which is one of the five top remaining banks in this country, and also who happens to be the largest shareholder of Wells Fargo is Warren Buffett, who found, in that company, the kind of ownership values and attitudes that he wants to see in the businesses that he brings into the Berkshire Hathaway company. So you're right – if the board is bringing in a company to execute a particular strategy which I think is a real problem, I would be worried about a board like that, because what you want from your chief executive is to be somebody that is able to think very strategically and tactically, but also have a visioning capability, because the world is changing so fast. If they're ever stuck on trying to execute something that people think needs to get done, and isn't thinking about what's around the corner, then whatever it is that they're trying to execute at that moment may not in fact be what is needed, given what the future is showing us. This is another reason why it's important to see if a company is a leadership culture, because in that kind of culture you've got lots of communication, so that a company is keyed into discussions with their customers and their investors, which gives them intelligence to understand better where, what the future's looking like, and how they need to adapt to it.

David:

But should we not also be appreciating the fact that the environment is changing all the time? And so therefore you do need chief executives that come in, that have special skills for that particular time in the company's development, and sometimes if you stick with the same CEO all the time, that may not be the right thing to do? If we go back to a company like, say, Apple, there was a period in Apple's development when Steve Jobs was probably the wrong person to be in there, and they had to bring in somebody from outside that had marketing experience, that did some good for Apple during that time. Obviously, the CEO that they did bring in didn't actually do that well after that period, when it was time for Steve Jobs to come back in again. So we have to accept the fact that CEOs are not multi-skilled in some situations, and that you do need somebody that has special talents for a particular time in the company's development.

Laura:

I think what you're speaking to, David, is a time meaning circumstances?

David:

Yes.

Laura:

But you cannot deny the importance of culture. A good case study in this example that you're offering is the experience at Home Depot, and this is a case study I'll be presenting in the new book I'm writing, called *Investing Between the Lines*, which will apply the principles that Warren Buffett uses in writing his shareholder letters, so the same principles to the letters of Fortune 500 companies. Home Depot was an amazing success story, started by Arthur Blank, Bernie Marcus, in Atlanta, Georgia, just a few small home development stores, and by the year 2000 it has just mushroomed into one of the top retailers in the country. But it had growing pains, just like you said, that it got to the point where it had grown so much, it needed some system, some centralising systems, to be able to manage the growth that they had. The company brought in Bob Nardelli from GE, and that was in 2000, and Bob has just lost out on the race to be named CEO of GE. So he came into Home Depot, I read his first shareholder letter, and I could tell there were going to be problems at the company. Here was a company where the culture was very much employee-focused; it was all about, the success of the company was based on having knowledgeable people at the store level who could help customers and sell product -- move product through those stores. Bob Nardelli came in and did what the board wanted -- he cut costs, he brought systems into place, but he killed the culture. By the time he left, the stock was trading lower than when he started, even though he had doubled sales and earnings. So they brought in, and at that time, as you recall, Lowe's was their key competitor, Lowe's significantly outperformed ... they continued the same kind of culture that had given Home Depot success. So Frank Blake came in, he took over from Bob Nardelli, and it was interesting, because you could see, just from reading his shareholder letters, they looked a lot like Bob Nardelli's until just recently, and you could see that now he writes letters that look like those letters written by the founders. Home Depot is outperforming Lowe's, and having real success again.

David:

And you can tell that just from reading the shareholder letters, Laura?

Laura:

Just from reading the letters. Now, I should say, I think it's important to mention, David, that what I'm talking about is a whole new field that's just developing. The work we're doing is on the cutting edge of this, and what it is is, a natural language processing. Because of computer technology, it's possible now to analyse language, and of course language is an indicator of your emotional state, but also your consciousness -- what are the things that you think about that are important? It's this consciousness that we look to when I read a shareholder letter. I've developed a model that has seven systems that make up a sustainable business, and I'm looking to see how conscious a CEO is of what's required for success in each of those systems; in other words, what's required for strategic success, accountability systems, leadership, relationships with stakeholders, and so on. I translate these findings in terms of language, I create a system so I can actually quantify the amount of content or consciousness. So I get really a very interesting picture of what's important to a CEO and the culture and the leadership, and that's what allows us to see what's likely to happen. In my book, I'm going to show how our metrics predicted the demise of Bear Stearns, AIG, Merrill Lynch; most recently the problems that Avon has been having. Those were very evident in the shareholder letters over the past eight years.

David:

So for the amateur CEO letter reader, can you give us maybe one or two pointers, one or two things that we should be on the lookout for, to try and identify a good CEO letter?

Laura:

The most important thing, David, is, and you can do this, by just taking a red pen -- read a letter, and circle all the words that are meaningless -- all the clichés, all the jargon, the jargon that's used instead of, I call it lazy writing -- instead of describing something accurately, they use a standard phrase. Just circle those words, and you get an indication right off the bat, how committed and conscious the CEO is of the need to communicate clearly. I'll give you a story about my cousin Nancy, who is a brilliant Chinese scholar. Her father was a stockbroker. When he died, she inherited the money that was put in a management fund, and she knew about my work. She never took a business course in her life, and her advisor put her into three gold stocks. So she asked him to send her the annual reports of these three companies. He did; she read them, and she called him, she said: "I don't want to hold this particular company, one of these gold stock companies." He said: "No, it's a great company. You really ought to hold it – it's going to do well." She said: "No, I just don't feel good about it." And so he sold it, and sure enough, three months later, the company tanked. It had accounting issues, the CEO resigned. She was able, she wasn't trained in business, but she was able just to see the difference in the authenticity and the clarity of these three different letters.

David:

So what you're saying is that, when shareholders are reading the CEO letters, if they find that there is too much fluff within the letter, does that automatically make it a bad shareholder letter?

Laura:

It's a flag, it's a red flag. If you wish, David, I can just read you a couple of sentences from the AIG 2010 letter?

David:

Okay.

Laura:

Okay, so this is the second paragraph, and openings are everything. Remember, a letter is like meeting somebody – you make a first impression, so you want to have a strong opening. This is how they report to their investors: "We've demonstrated the strengths of AIG's core businesses" (but they don't tell me what those core businesses are!) ... "but they have enabled us to remain market leaders" (but who says they're market leaders? – give me some third-party validation) ... "and this is supported by our powerful culture of entrepreneurism and innovation". Now, this raised bells in my mind, because here was a company who almost went out of business, without the taxpayer bail outs, because of this so-called innovation where they were packaging these mortgages into securities that ultimately had no value. I would prefer that they had a powerful culture of stability, and less innovation.

David:

So are you also saying, Laura, that had the chief executive taken some lessons about how to write a shareholder letter, he could literally pull the wool over the eyes of shareholders, by instead of just using fluff, use something that was actually more concrete? And then it would come up with a higher ranking on your written house ranking charts?

Laura:

That is possible, David, that is possible, but again, in my experience, I have found it almost never happens, because if you're required to live in the real world, and are required to deliver substance, it requires a lot of soul-searching. I actually work with companies, I don't write shareholder letters, but I act as a coach to companies. One of the things I tell companies, the shareholder letter is like a strategic physical. You go in to see your doctor once a year to have a check up, to see how are my systems functioning. When you're in business, you're running flat out almost all the time. You never have time to step back and reflect on, where am I? Where have I come from? Where am I going? – and that's what a really smart CEO does, when it's time to write that shareholder letter. It's a time to step back, to get his key teams, his or her key teams, together, and say, what is it that -- it starts with this: what is it that our owners want to know? And just to that point, what is it that our owners want to know, what are the most important questions that we need to address? What are they sceptical about?

David:

I know also that you've just recently been to the annual general meeting of Berkshire Hathaway in Omaha, and one thing that I would like to know is, there was recently a statistic that came out to say that his Berkshire Hathaway investment company has underperformed the Standard & Poor 500 index for the third straight year. Now, how can he possibly reconcile that with shareholders, by holding up his hands and saying, yep -- I've underperformed the market for three straight years now? It isn't a very easy thing for any chief executive officer to say, is it?

Laura:

It's not easy to say, and I think you've done this, David, but it is again so contrary to the way people think about investing in Europe, and I know that there's a lot of buzz now about the elections in France, the huge unemployment in Spain – serious, serious problems. So it's important that people take a long view, because the short view that, in my view, the short term perspective that is very much in the way that so many people invest these days, it's going to make it really difficult to come up with solutions to these problems, because these are long term problems. So what do I mean by Buffett? Anyone that's read his shareholder letter knows that, besides death and taxes, there's one thing you can count on, and that is, for the last, whatever it is, 42 years, Warren includes the first page, before he gets into his shareholder letter, is a list showing how Berkshire has performed in terms of its book value, versus the increase, or decrease, in the Standard & Poor's index. So he's not looking at his stock price, he's looking at his book value, and as he has said frequently, if you look at the stock price, that's governed by earnings, and there's all kinds of manipulations and foolishness that goes on in calculating earnings. But book value is book value -- that's where the cash resides. That's where the asset values reside. That's the cash-producing engine of the company. So he would say, yes -- we're underperforming the market, but in fact, in 2011, the book value did better than the S & P 500. So, that's a long answer, but in order to understand Buffett, and also to understand, I think, what more investors need to look at, is, that is a very important distinction.

David:

And also, with regard to the annual general meeting in Omaha, what did you take away? Because I know you went there, so what did you take away from what Warren had to say during the meeting to the shareholders? Can people communicate verbally, as well as using their shareholder letters, to try and get a message across to the investors?

Laura:

The meeting this year had a very interesting format. As you may know, David, there's only two companies that invite shareholders to their meetings in the shareholder letter, and that's Costco and Berkshire Hathaway. There may be others, I may not have read them, but of all the letters I've read, those are the only two. So 30,000 plus shareholders showed up from around the world in Omaha this weekend, and they came to sit in a dark auditorium that seats about 20–25,000 people, and they sit for six hours, listening to Warren and Charlie Munger, his vice chair, answer questions. Democracy is about dialogue and discourse, and this is probably one of the best examples of it, certainly in the United States. But this year, what the format is, that journalists, three journalists ask questions of Warren and Charlie. This year, they included three insurance analysts, financial analysts. Then they rotate around the entire auditorium, and people, shareholders who come from wherever, are invited to ask their own questions. So it's a real dialogue, and as you might expect, this year Warren got tough questions about succession.

David:

And what did he say about that?

Laura:

He said what he's said all along, and what I think is interesting is, he said that the person that they've picked is someone that is well known to the board; that will carry on the Berkshire culture, and therefore the performance; and, even though there may be some deficiencies in that he won't have Warren's reputation, and that reputation that Warren has is very important for his ability to get and construct investments that probably nobody else can, just simply because of his reputation, but you would imagine, over time, whoever this individual is, that will be the case. But he said that whatever he lacks in that, he'll make up in energy, because he's going to be probably more aggressive and more energetic than Warren is. So again, he would not name who the successor was, but I don't know any CEO in his position that does name that successor. Until the CEO decides to retire, in almost all cases, that's when the new CEO is named, and the reason is obvious -- things can happen; it just makes for a cleaner transition. But obviously, with Warren's age and the reputation that he has, it becomes a much more interesting question.

David:

And did he also give some clues as to how he sees the global problems that are happening? We are here in Europe, and we are getting, almost on a daily basis, a diet of news coming out from Europe. Is he worried in any way about what is going on in Europe?

Laura:

He and Charlie Munger both have said for many years, and I've been to meetings for the past 16 years, so I've followed this pretty closely, but they've said for the longest period, when you have a situation where you have the economics of these countries are organised and co-ordinated, but the political systems are not, you're going to have a problem, so I think anyone would be worried about what's happening. The meeting concluded yesterday with these words -- you might appreciate them. I think they apply in many cases, David. This is what Charlie Munger said, when someone asked him, what can we hope for in the United States? – and Charlie said, "We need one more sacrifice, more patriotism, more sensible ways of spending government money, and more civilised politics."

David:

But did Warren mention anything about the Buffett tax? In other words, the rich people have to pay more taxes? Did he say anything about that at the meeting?

Laura:

There were incredible exchanges about that, and he re-stated the position, because it's been misinterpreted many, many times over. His position is, he's always, always ... in the book you and I talked about a year ago, the book I wrote about his shareholder letters, *Buffett's Bites*, tells the story of his father, who was the epitome of a fine, upstanding America, who, when he was elected to Congress from Omaha, the Omaha district, when he got to Congress, Congress voted themselves a raise. Warren Buffett's father refused to accept the raise, because he said, "I was voted, I was elected under this salary, and that's the salary I'm going to take." So Warren has a very strong view of fairness, and everyone, the whole premise of America is supposed to be, everyone gets a fair shake. So all he's saying is, if I'm paying, he said, I've paid 17% tax, even though I'm making millions of dollars, and everybody in my office is paying 30% plus. I should at least pay 30%, like everybody else. So that's his position. As Charlie Munger said, it doesn't make him popular at the country clubs.

David:

I'm sure it doesn't, no.

Laura:

But when someone asked, do you think it's your role as a CEO to be speaking out on these issues, if it could be hurting the business? Warren's reply was very, very immediate and very clear -- he said, when I became CEO, I did not put my citizenship in a blind trust.

David:

Wow! Those are very powerful words.

Laura:

Very powerful.

David:

Okay, so earlier on in the podcast, Laura, you mentioned this new book of yours: *Investing Between the Lines*. When is this one out?

Laura:

It'll be out in early December.

David:

Just in time for Christmas?

Laura:

That's exactly right, David.

David:

I can't wait to get hold of that book, so I can have another opportunity to talk to you again, once I've finished reading it.

Laura:

Well, if you have any questions, you know how to reach me, David.

David:

I do, so I just want to thank you for joining me today, Laura. As always, it has been an absolute delight and pleasure. Now, I have one more chore to perform, and that is to find a quote to sum up today's podcast. Today's quote comes from a Japanese proverb, which says: "The reputation of a thousand years may be determined by the conduct of one hour", and I think that is probably a shareholder letter. In that short piece, you could actually determine your reputation of a thousand years, in just a few hundred words.

Laura:

Very well said, David.

David:

Okay, that's wonderful. This has been Money Talk, I have been David Kuo, and my guest has been Laura Rittenhouse of Rittenhouse Rankings. If you have a question about the podcast, don't forget to post it on our Money Talk web page, which you can find at fool.co.uk/podcast. Don't forget, you can also submit suggestions for future shows to me at moneytalk@fool.co.uk. Until next week everyone, have a great week!